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THE REAGAN DEFENSE BUDGET: PROSPECTS AND PRESSURES,(U)

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THE REAGAN DEFENSE BUDGET: PROSPECTS AND PRESSURES

Kevin N. Lewis

30 December 1981[1]

Abstract: In this paper, I will discuss the ways in which a range of possible outcomes of the Reagan Administration's economic program could help to reinforce or undermine the prospects for real U.S. defense budget increases on the order of those presented by the President in March 1981. The prospects for planned real budget growth (which had been projected by some officials at 7% per year, in terms of outlays) could be rendered fairly bleak should the overall Federal economic plan fail. Under any circumstances, moreover, the political rationale for maintenance of significant real DoD budget growth can be expected to remain in a state of conflict with other components of the Reagan economic plan. Too, whether or not the Reagan economic program is successful, powerful pressures and restraints will undoubtedly shape the internal mix of the defense buildup.

Background of the Defense Budget Controversy

In November 1980, Ronald Reagan was elected to the U.S. Presidency by an overwhelming electoral college margin. The two most important themes in Mr. Reagan's campaign had been: (i) the need to reorient economic policy and to stimulate U.S. economic growth; and (ii) the urgent requirement to build up America's defense capabilities. The former theme is a traditional element of any campaign, although Mr. Reagan proposed to base his policies on an economic philosophy that had not enjoyed prominence in national policy theretofore. Popular interest in rearming the U.S., on the other hand, reflected a fairly young national consensus that the world had indeed become a more dangerous place in which to live.

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[1] The views expressed in this paper are the author's own, and are not necessarily shared by Rand or its research sponsors. This paper was prepared for presentation at the Institute Francais des Relations Internationales' "Ramses II" symposium at Paris in the Fall of 1981: a version of it will appear in the Ramses conference proceedings.

Unfortunately, it now seems as though these two top national priorities are destined to be increasingly inconsistent ones. Continued full adherence to plans for accomplishing either one along the lines laid out by the Administration may directly or indirectly jeopardize the other's chances for success.

That such a difficult and important tradeoff exists is clear from inspection of the year's budget developments. Throughout 1981, the Nation has observed a vociferous debate over the FY82 defense total and the FY82 Five-Year Defense Plan ("FYDP"). A curious coalition of the Office of Management and Budget, both liberal and conservative Congressmen, and others has repeatedly recommended cuts in the defense program as a means of achieving other economic goals (most notably an earlier balanced budget) or to avoid deeper cuts in domestic programs and entitlements. They have been opposed by an equally vigorous alliance, led by Mr. Weinberger, that has stressed the risks attendent upon national security budget cuts. Naturally, in addition to the macro level dispute over the DoD "top line," debate has fulminated over the internal mix of the posture: the most notable case-in-point was the question of which package of strategic nuclear systems should be bought.

On account of this controversy, this year's U.S. defense debate has been a turbulent and exhilarating one. On 18 February, the President indicated that military spending would increase from 24.1% of Federal spending to 32.4% between FY82 and FY84. In addition to requesting a \$1.3B FY81 supplemental, on 4 March Mr. Reagan added \$7.2B in new FY82 outlays, which, along with \$2.9B in cuts, boosted the FY82 total from \$180B to \$185.5B. The new TOA implied by these actions amounted to

about $6B in FY81 and $26B in FY82, yielding a FY82 TOA of $222.2B. This represented a significant increase above the final Carter administration budget--itself a 23.8% increase over FY81 levels measured in current dollars--of $196.4B in TOA, and $180B in outlays.[2]

Looking to the outyears, outlay add-ons for FY83-86 of 20.7, 27, 50.2, and 63.1B were announced. Thus, the value of the Five Year Defense Plan for FY82-86 was to be about $1.64 trillion in TOA and about $1.45 trillion in outlays. In total, the average annual real increases in defense in the Reagan FYDP were then to amount to 9.2% in TOA and 8.4% in outlays, compared with 5.5% and 5.0% for the Carter plan.

At the time, the Reagan defense plan was strongly endorsed by Congress and was favorably received by the public. Throughout the spring, Reagan pledged that the Defense Department would not be subject to the first round of Federal budget cuts. And, reflecting the national pro-defense mood, Congress acted with great speed in May to basically back the Reagan plan.

Shortly, however, ominous economic indicators prompted OMB and some members of Congress to take steps to cut the defense budget. In mid-July, the Defense budget was quietly trimmed by roughly $3.4B. And though the Defense budget had been declared "out of bounds," in August, Administration spokesmen claimed that a proposed 7% annual real increase was a target, and not necessarily a firm commitment.

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[2] For background data, see Harold Brown, <u>FY82 Annual Defense Department Report</u>, January 1981, and Reagan Administration, March 1981 <u>Budget Revisions</u>, Office of the President. Note that the FY82 Carter budget represented a 9.1% increase over the FY82 budget envisioned in the FY81 FYDP.

Subsequently, a range of substantial OMB cut proposals were prepared and circulated. (The most severe of these amounted to $58.8B through FY84.) Rumors circulated that White House approval of a three year cut of as much as $50B was imminent. And, early in September, White House aides indicated that the President might cut as much as $30B from the defense program, a possibility that mobilized substantial opposition within the Defense Department and elsewhere.

To settle the issue of how much, if anything, should be cut from the defense budget, the President, Mr. Weinberger, and Mr. Stockman then agreed to the following arrangements, among others. Total cuts in outlays for the FY82, FY83, and FY84 budgets of $13B were planned: $2B in FY82, $5B in FY83, and $6B in FY84, (bringing the total cuts for those three years to $16.4B, including the July cut). This relatively mild action was announced on 12 September. Another important decision made was to set future budget levels in terms of outlays, not TOA. (Of course, depending on the programs bought, TOA could vary substantially over that period, a point to which we will return later.)

As the pinch on domestic programs came to be felt and as recessionary conditions worsened and triple digit deficits loomed, redoubled efforts were made by some Congressmen to obtain further FY82 cuts, amounting to something on the order of $5B or even $6B, as compared to the $2B announced in September. For a while, Congress held the FY82 budget "hostage" by delaying passage of a final bill until tax changes or a second round of defense cuts were forthcoming. In addition, OMB continued to press for significant near term defense cuts. The outcome of this struggle apparently was decided in the short run in the

Administration's favor, for a final defense bill of $206.9B in TOA was passed on 29 December. Table One summarizes the year's budget developments.[3]

Table One
Proposed and Actual Status of the FY82-84 Defense Program, Jan-Dec 1981
(in billions of current dollars)

	FY82 TOA	FY82 Outlays	FY83 TOA	FY83 Outlays	FY84 TOA	FY84 Outlays
Carter 15 January	196.4	180.0	224.0	205.3	253.1	232.3
Reagan 4 March	222.2	184.4	254.8	221.1	289.2	249.8
Reagan 15 July	---	183.8	---	219.9	---	248.6
Proposed OMB Cut Alternatives (August)						
Level I	221.9	183.6	247.3	219.2	278.4	246.9
Level II	221.4	183.4	238.5	217.4	276.9	243.5
Level III	216.0	182.0	225.3	211.2	266.1	234.0
Reagan 12 September	214.1*	181.8	---	214.9	---	242.6
Congressional Action 29 December	206.9**	[181.8]***	---	---	---	---

* Implied TOA
** Enacted, $199.8B, plus $7.1B MilCon
*** Latest Value

[3] Sources, FY1982 Defense Report; "Pentagon Budget to Rise $7.2 Billion for Fiscal 1982," Wall Street Journal, 19 February 1981; "Reagan to Request $38 Billion Increase in Military Outlays," Washington Post, 4 March 1981; "Spending Report Due on Military," New York Times, 24 August 1981; "Pentagon Told to Prepare 'Reverse Wish List' of Cuts," Washington Post, 1 September 1981; "Reagan Decides to Cut Defense by $13 Billion," Baltimore Sun, 14 September 1981; and "White House Cut Pentagon Budget Twice," Armed Forces Journal International, November 1981. Recall that the inflators used in these tables are different between the Carter and Reagan budgets. The most recent outlay figure corresponding to the FY82 package going into December was $181.8B, although this can be expected to change.

Although it seems that the President has won this round of the defense budget controversy, the question of interest is what the future may bring. In particular, can currently planned DoD budget targets be met in FY83 and FY84? The answer to this question will depend on how a balance between two factors is struck.

On the one hand, it is possible that economic problems will continue for more than just the short run to bedevil the Reagan economic program. Already, the aim of balancing the budget by 1984 has been abandoned. The scheduled end to the current recession has also slipped repeatedly. And though interest rates have declined somewhat, that downturn has not gone as far as hoped and there is great concern that big deficits could start rates climbing again. On the other hand, international developments, such as the recent turmoil in Poland, Afghanistan, North Africa, Latin America, and elsewhere, will continue to ensure that ready and capable U.S. defenses remain a top priority.

But despite the grave nature of these many crises and threats, it is likely that top lines for FY83 and FY84 and beyond will be subject to considerable pressure, because the big defense buildup depends in large part on the success of the Reagan economic plan. Of course, should some major crisis materialize (say, in the aftermath of a Soviet intervention of Poland, or in the wake of some Middle East conflict), we can expect the defense budget to have a relatively unrestricted call on the Nation's resources. But in the following pages, let us consider the case in which no such emergency arises.

Economic Factors Affecting the Likelihood of Major Defense Growth

According to the economic doctrine on which Reagan policy has been

based, U.S. defense spending can be significantly increased in real terms at the same time that major taxes are reduced and the Federal budget is slowly balanced. Many people have speculated on the prudence, propriety, and the chances for success of the program, but it is genuinely difficult to say now whether or not President Reagan's master economic plan will work. On the one hand, interest rates have not abated to the degree hoped, a recession is in progress, and much larger than expected deficits loom. On the other hand, there is no doubt that much of the Reagan administration's economic legislation will take some time to work.

To defense planners, however, the plan must not only work, it must work fairly quickly. This is because the deficit problem will place a heavy premium on "up front" outlay reductions. An even greater fear among some U.S. defense planners is that the overall economic plan may fall rather more short of goals than just missing schedule milestones. In either case, a substantial body of public opinion holds that the chances for the defense buildup would be poor given the political consequences of abandoning the non-defense components of the Reagan economic plan. One commentator, former Defense Secretary James Schlesinger, offered this fairly grim assessment:[4]

> "Unless the tax reductions are reversed--which seems unlikely--on the basis of present legislation and projected defense spending, the nation faces growing budget deficits of $65 billion in 1982, $90 billion in 1983, and $120 billion in 1984. Non-defense reductions

[4] James R. Schlesinger, "A Budgetary Dunkirk," The Washington Post, 9 September 1981.

> will be increasingly hard to achieve. Thus, only the total jettisoning of the Administration's goal of a a balanced budget will permit even a modified defense buildup to survive."

It should be noted that some authorities, including Mr. Stockman, have predicted that FY82 deficits could run to $100B, and that this figure could subsequently grow at a rate of $30B per year.[5] And unless inflation rates decline as predicted, FY83 budget targets will be missed, and defense spending will be subjected to even greater pressures. For instance, if inflation runs to 10% or 11% this year, the budget will be $50B to $75B in the red above and beyond the approximately $40-50B in new cuts that have to be found, at least under current plans. Given the repeated reendorsement of the compromise three year 25% tax cut, future cuts will have to come either from entitlements and other "hands off" non-defense programs or else they will have to come from the defense program--unless the Administration is willing to live with huge deficits. If not, some of the reductions presumably will have to come from defense. In fact, under these circumstances, and even with some encroachment on the "safety net," just to think about balancing the budget by, say, FY86, FY83-85 defense cuts on the order of $15B to $40B would be required, which could hold currently planned real growth to 3% real, or even less. Under these conditions we are left with a very antagonistic standoff between the goal of increased defense capability and the foundations of the original Reagan economic plan.

In sum, the failure of the Reagan economic program could bode ill for the Administration's expanded defense effort. The Administration

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[5] Richard Cohen, "Unbalancing the Budget: Congress Fights Back as Tide Runs Red," The Los Angeles Times, 20 December 1981.

obviously retains the right to select its own allocation of "lumps" in the event of a worsening Federal budget situation. However, based on historical experience, it is rather safe to say that defense is a relatively likely target compared to some of the alternatives. This is no consequence of "supply side" or any other approach to economics: it is attributable to the incontrovertible fact that the Defense budget is the largest source of controllable Federal outlays and therefore is the logical target of anyone who attempts to reduce overall Federal outlays.

Figure One portrays the constitution of Federal outlays between FY50 and FY80.[6] In constant $FY82, we see that while Federal outlays have increased by roughly three-fifths over this time, DoD remained roughly constant in real terms after FY53, explaining its decline from 41.7% (in FY64) to 22.8% (in FY80) of the overall Federal budget.

Despite the dramatic growth of the nondefense slice of the budget, however, the national defense continues to represent the largest share of controllable Federal outlays. An outlay for a given fiscal year is said to be relatively <u>uncontrollable</u> if the program level is determined by factors beyond the administration's control. There are two general types of relatively uncontrollable program. First, there are open-ended programs and fixed costs, which mandate some payments for a given fiscal year in accordance with legislation in force at the beginning of that fiscal year. Second, some outlays are required on account of gally binding prior year contracts and arrangements.[7]

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[6] See <u>Budget of the United States Government for FY1982</u>, Executive Office of the President, Office of Management and Budget.

[7] ibid.

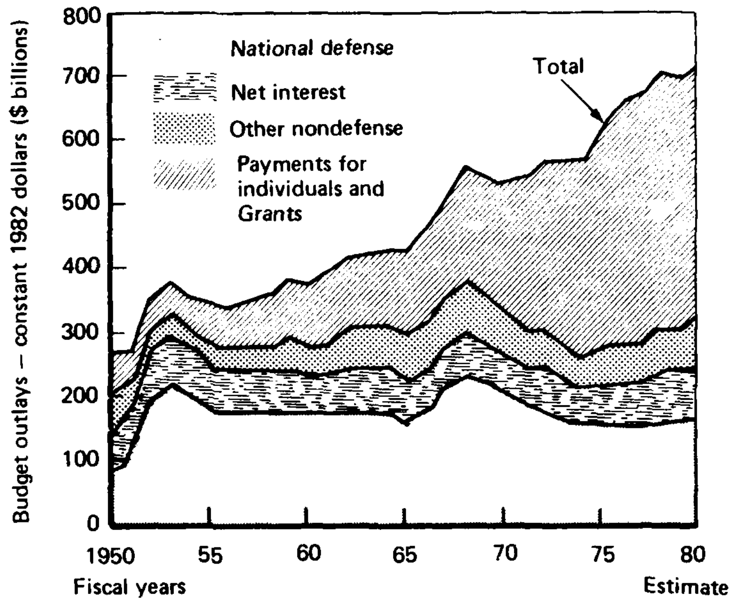

Fig. 1—Breakout of U.S. Federal outlays

Nearly all of the first type of relatively uncontrollable accounts are non-defense. The largest component of these outlays is payments to individuals, particularly Social Security and certain retirement plans. Other payments go to health care programs, unemployment assistance, housing and nutritional assistance, and so on. In addition, there have in recent years been on the order of about another $60-70B in other outlays, mainly for national debt service. In all, fully 60% of Federal outlays for FY82 were relatively uncontrollable under present legislation. Yet, of these payments--amounting to an estimated $448B in the initially submitted Carter Administration's FY82 budget--national defense related outlays were only $16B for Military Retired Pay.

In addition, some payments are required because of preexisting obligations. Again using the Carter figures, in FY82, such programs amounted to about $119B, of which $52B or 43.7% were related to the national defense. In the case of national defense programs, much of this amount was money previously appropriated for procurement programs that spend out slowly, such as ships and airplanes. Adding together both types of uncontrollable outlay, then, we see that $566.4B, or fully 76.6% of all Federal outlays, were more or less untouchable before a fiscal year begins.

The remaining 23.4% of controllable outlays, however, reside primarily in the national defense budget. Of $180B in controllable FY82 accounts, $117B were national defense outlays. Hence, of total national defense outlays of $185B, 63.2% were controllable; of nondefense outlays of $562B, only 11.2% were controllable. Figure Two summarizes these facts and indicates very clearly why national defense outlays are sub-

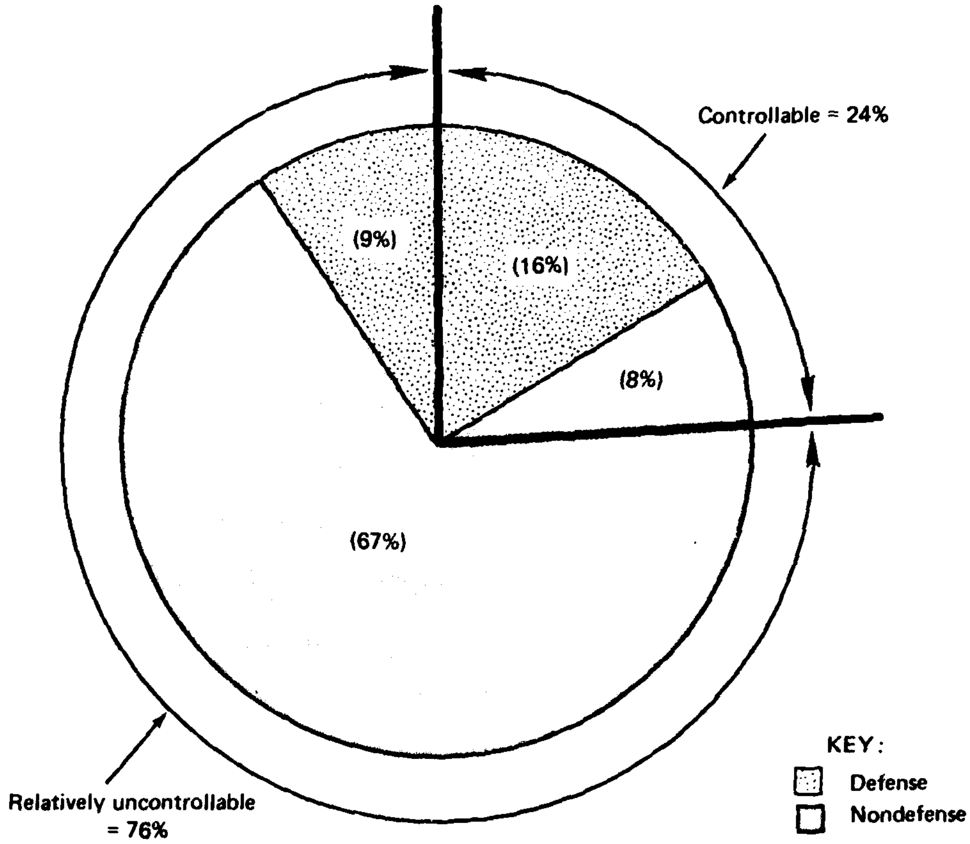

Fig. 2—The controllability of the U.S. Federal Budget

ject to attrition as the budget moves through Congress.[8] True, the Reagan administration has undertaken to revise legislation applying to some uncontrollable programs, and more action is contemplated. But taking into account the highly politicized nature of most uncontrollable outlays, it is clear that budget cutters will continue to eye the national defense budget.

For this reason, the Defense budget traditionally is drawn down throughout the course of its passage through Congress. This is so even when a pro-defense mood prevails in the Legislative branch. Figure Three indicates the often substantial effect of mainly Congressional action on defense budgets.[9] Here, the difference between submitted and actual Budget Authority has run to roughly \$100B in \$FY80 over this 15 year interval. Though some of this effect is distorted by other kinds of political phenomena (e.g. lame duck budgets and treaties), the implications for future increases are clear. True, it is clearly impossible to extrapolate from such results a deterministic estimate of the consequences or likely directions of Congressional action in the future. What Figure Three does reveal, however, is that we should take pains to recall this traditional erosion in submitted budgets as we prepare future defense budgets.

In other words, even if the Reagan scheme works out, traditional pressures to rein in outlays will, at the least, be a major source of friction among defense and economic policy makers. The most significant problems will relate to the internal mix of the defense program. In the

[8] ibid.
[9] Source, Department of Defense Annual Reports, FY62-FY80.

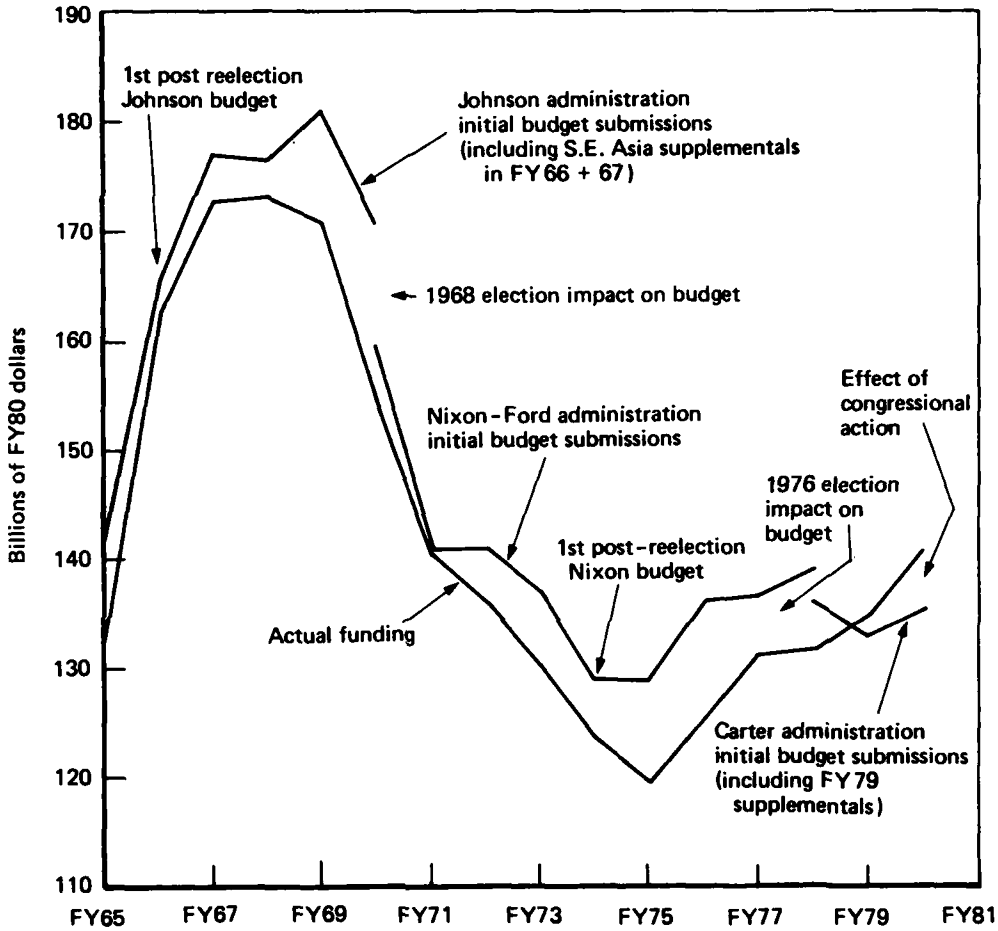

Fig. 3 — Defense TOA

case of the defense budget top line, however, there are a few factors worth mentioning. The definition of a baseline for real growth and the selection of a different accounting scheme, inaccurate inflation estimates and the fact that defense activities often experience higher inflation than the civilian economy, and the short range requirements of the Defense Department could dilute the total Reagan defense program, at least over the near term, even if the Reagan economic policy is ultimately validated.

Initially, one of the most important factors influencing the degree of increase in the U.S. defense budget concerned the selection of a baseline value for use in determining outyear budget targets. Following the substantially amended FY82 budget (at first a 13.3% increase in TOA over the budget submitted initially by the Carter administration, and finally about a 9% increase over that submission), the Reagan administration promised a 7% per year real increase in TOA. The 7% rate, if it remains in force, is to be based on some FY82 baseline yet to be selected. (Mr. Stockman is said to have recommended, and was apparently overruled on the suggestion, that the FY81 appropriation of $176B be used). Looking out through the FY82-86 FYDP, the difference between 7% growth based on the initial March 1981 Reagan top-line ($222B) and a final TOA $206.9B would be $86.8B. (For the sake of comparison, the March proposals would differ from an FY81 baseline by $148.4B). It has not been clear exactly which budget will be selected for use in defining a baseline value. What is clear, though, is that the choice of one or another value could have an important bearing on five year program totals.

But recently, for the most part, the issue of constant real growth rates seems to have fallen by the wayside. One explanation lies in the September 1981 Administration decision to consider budget totals in terms of outlays.[10] The significance of this choice is as follows. Different defense activities spend out at different rates. Some accounts, such as Operations and Maintenance and manpower-related expenses, spend out very quickly, that is to say, TOA tends to be converted to outlays in the same year. Other types of programs spend out very slowly: for example, only about 2% of TOA for an aircraft carrier is spent in the first year; the corresponding figure for aircraft increasingly is on the order of 25%.

Thus, if there is an immediate outlay "crunch," as there now seems to be, we can in effect hold down short term outlays by buying weapons that we can pay for on a several years' installment plan.[11] It is partially for this reason that, while the current Reagan and the submitted Carter budgets show about the same amount of outlays, their TOA figures are so different. But, it is not now clear what TOA--and hence the

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[10] Note that programs normally are costed and budgeted in terms of TOA, so the use of outlays in this manner contributes to confusion in developing overall budget plans: indeed, it simply is not clear as of this writing what FY83 and FY84 TOA figures will be.

[11] Other tactics to hold down outlays exist. For three months the FY82 defense budget was subject to a continuing resolution: funding had to remain at FY81 levels, and no new program starts were permitted. The FY82 program, however, includes a variety of measures to improve operational readiness: more flying hours, training activities, etc. Because these involve immediate outlays the continuing resolution in effect held down outlays, albeit at the expense of readiness. Another approach is to schedule some kinds of activity for next summer, and attempt to defer FY82 outlays into FY83, and thereby charge them to the next fiscal year. Other approaches come to mind, but it is clear that neither these nor reformed management procedures will relieve overall pressures on the defense budget.

defense program--will be even in the next couple of years. Thus, real TOA growth in theory could even exceed 7%, depending on what packages of forces are bought. This would burden the FY83-85 budgets for the sake of current ones.[12]

A second factor to keep track of in the Reagan plan is an abrupt lowering of predicted inflation rates. The relevant figures are as follows:

Table Two
Inflation Projections

Fiscal Year	Projected Inflation	
	Reagan	Carter
82	8.4	8.9
83	7.0	8.6
84	6.4	7.6
85	5.4	7.0
86	5.0	6.6

Naturally, if these rates are exceeded, the constant value of the defense outyears is eroded and so adjustments to budget submissions--not likely to be very well received politically--or even worse, requests for supplementals, will have to be endured. In addition to the obvious macroeconomic implications of continuing high inflation for the overall Federal budget, the DoD budget suffers unique problems with inflation. If inflation cuts too much into planned real growth, programs will have to be cut back, usually with production diseconomies. Military, civilian, and retired pay accounts can be particularly hard hit.

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[12] To illustrate the possible degree of a future outlays "crunch," consider the implications of the current Navy force expansion program for SCN outlays in the FY83-85 time-frame. Plans to build to a 600 active ship Navy could cause unobligated balances to increase from current levels of $12-15 billion to as much as $25-40 billion (in constant dollars), depending on a variety of assumptions.

Unfortunately, when it comes to predicting inflation accurately for defense planning purposes, the record is poor. Between FY70 and FY80, cumulative inflation was estimated a priori as 83%, but actual inflation was 121.6%. A similar degree of bias in the future would have the effect of reducing 7% real growth to 3.1% growth. A related serious problem is that inflation in defense programs tends to be greater than that in the general economy.[13] And in addition to faster-than-CPI growth in many areas (energy, advanced technologies, strategic materials, shipbuilding, to name only a few), future cost projections have typically been plagued by unrealistic personnel compensation assumptions. All of these factors would in effect impose a considerable virtual attrition on the budget.

Finally, efforts to increase the readiness of the force will have an impact on overall budget totals over the very short run, particularly if the Defense Department commits itself to taking care of the effects of past underfunding. The defense buildup cannot wait too long for the realization of the Reagan administration's economic targets. Particularly in the sensitive field of readiness, outlays over the very near term are needed. Though some means exist for softening the impact of current and near-term outlays in the defense area, there are limits to the extent to which outlays can be deferred. Continuing short run economic difficulties, then, may accrue which will feed back on other elements of the economic program.

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[13] DoD is said to have proposed use of special inflators for defense budget preparation, but been rebuffed. However, specialized inflation factors (similar to those that have been used for costing the shipbuilding program for some time) will be used for aircraft and a few other special kinds of investment beginning this year.

The critical point to be made here is that, for these and other reasons, the FYDP is a fairly unreliable indicator of future budget directions. Indeed, the FYDP was not designed for this purpose: its role was initially intended to satisfy the less ambitious requirement for a bookkeeping device to show the future implications of buying a particular package of defense programs. But now the plan has, to some people, come to have significance above and beyond this, and disappointment frequently is in the offing. Figure Four shows the evaporation of estimated future increases (averaged from a baseline of the date that the budget was submitted of 1.00) as the outyear target dates approach the future. These values are from the FY77 budget (when declassified FYDP values were first presented) to the present date. In sum, and even if the Reagan economic plan works out, it seems that there are strong incentives for holding down outlays over the short run.

A Few Key Issues Affecting the Internal Mix of the Defense Budget

So far I have briefly reviewed the relationship of the Federal economic program and top-line Defense budgets. However, it is also worth mentioning a few ways in which economic developments can affect the internal mix of the defense program adversely. Generally speaking, any tightening in the Defense program is likely to hit U.S. weapons programs especially hard. Put another way, while DoD tends to be the discretionary slice of the Federal budget, Procurement is the discretionary title within DoD.

This, of course, is most unfortunate for two reasons. First, seriously disproportionate investment imbalances have been the most shocking

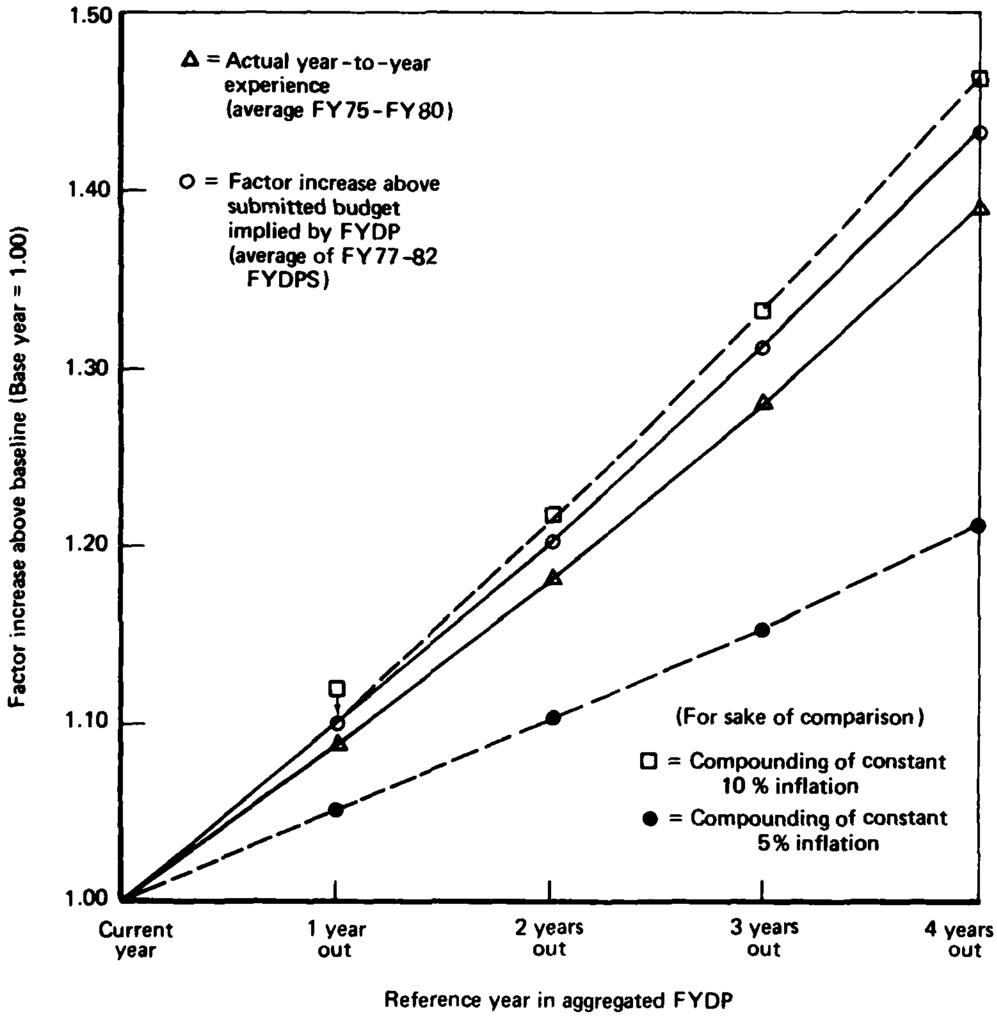

Fig. 4 — Materialization of five-year defense plan

of all aspects of the U.S.-Soviet military competition during the 1970s. The Soviet lead in defense spending overall during that decade has run to 50%, but in procurement the difference was a whopping 85%, on account of relatively smaller Soviet personnel and other operational costs.[14] Second, a number of U.S. programs, particularly Army and certain minor procurement programs, have been seriously underfunded in the past and are now all entering procurement concurrently, threatening a tremendous (and apparently unaffordable) "bow wave."

Because the posture is the cutting edge of the defense program, the Reagan Administration wisely committed itself at first to fleshing out existing capabilities, rather than to increasing the size of the standing forces, There is no question that significant real increases are needed just to buy completely the current posture. Indeed, Secretary Weinberger has said that it would cost $100B or more to just fix up the existing basic force structure without any increase in posture or responsibilities. This $100B, of course, represents nearly all of the increased outlays forecast in the ambitious first Weinberger FYDP, even given no increases in ongoing, or starts for new, programs. And to flesh out the new and ongoing programs in the last Carter budget could require an additional $15-25B a year above and beyond the requirement for "one shot" accrued posture repairs.

But although Mr. Weinberger is said to have advised the services in the Spring of 1981, "for the near term, our priorities are to improve

[14] See A. Alexander, A. Becker, and W. Hoehn, "The Significance of Divergent U.S.-USSR Military Expenditure," Rand Note N-1000-AF, Santa Monica CA, February 1979. The imbalance promises to get worse over the short run as some Soviet long range investment programs (in RDT&E and in defense industrial base) now begin to pay off.

capabilities of existing forces before increasing force structure" there has been a great deal of interest in force level augmentation. There were proposals, for instance to add nine new tactical Air Force fighter attack wings and three army divisions and to build up the Navy to 600 active ships (based around 15 carrier groups). These increases probably can not be sustained if the goal of fixing up a decade and a half's underfunding of the posture is maintained.

Again, take the Reagan Administration's plan to shore up U.S. maritime superiority as an example of the consequences of attempting to pursue force level increases. To build to a 600 active ship Navy by 1995 will require about $13.0 billion a year in average annual investment in shipbuilding, conversions, and acquisitions, measured in $FY80.[15] This compares to an average annual fleet investment of only about $5.7B during the decade FY71-80. Note that these figures refer to SCN only, and do not include extra manning requirements, the costs of aircraft and other weapons, more steaming days, etc. Adding in these latter expenses, the costs of building up to 600 ships could amount to between one and a sixth to one and a third of the total proposed annual average (7%) real budget increase. Thus, the Navy buildup plan alone would consume more than the planned real budget increase even with present assumptions about inflation. Unless the 7% figure were to be increased, in other words, some cuts would have to be found in current defense activities.

[15] See the author's "Investment Requirements for a 600 Ship Navy," Rand Paper, forthcoming.

A resolution to increase force levels at the expense of fleshing out current capabilities could have several adverse effects.[16] Not only will short term improvements in readiness suffer. An emphasis on major system procurement may exceed the ability of the industrial base to support the buildup. And we may, in the interest of deferring near year outlays, allow the recent trend of growing unobligated balances forward to continue. Growth in unliquidated obligations in a sense ties up resources, since outlays are not being pushed out fast enough.

As a result of several factors, procurement has suffered as a share of the overall defense budget. Over the past two decades, Procurement declined from 30% of the defense budget to around 20%. Moreover, there is, in addition, a major procurement/minor procurement imbalance. And not only has procurement as a whole declined. An additional pressure on procurement accounts is that many types of weapons grow in cost in real terms from generation to generation. Even if force levels are held constant, in other words, we will have to pay more and more over time to replace the "building blocks" of the posture--the tactical air wings, the carrier battle groups, and so on. This is principally due to the increased sophistication of some systems (to achieve higher performance, meet tougher threats, and so on), but it is also due to other factors including procurement inefficiencies. It is hard to say exactly what

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[16] For a general discussion of some of these issues, see William W. Kaufmann, "National Defense," in J. Pechman, ed., Setting National Priorities: the FY82 Budget, the Brookings Institution, Washington DC, 1981. Part of the overall Reagan defense plan has been to do "more with less." Hence, considerable attention has been paid to reforming the defense management process and to locating "unnecessary" programs. Despite some proposed management reforms, e.g. multi-year procurement, failure to cancel some programs in order to permit others to run at sufficient rates will exacerbate investment increases.

"modernization inflation" amounts to, but for leading types of weapons it seems to fall in the 2-10% per year range. This means that, over the long run, the posture will be hard pressed to expand in terms of force levels unless procurement budgets reflect higher replacement costs.

Finally, predicted procurement increases in recent years have tended not to materialize. Figure Five shows that, as a budget goes from Congress into its final state two fiscal years later, the effects of reprogrammings, rescissions, etc. have usually been at the expense of procurement.[17] The net result is often a situation in which procurement programs, initially underfunded, are moved into production and must be then bought at increasingly slow rates with serious implications for overall efficiency. Thus, while Federal cuts affect the DoD top line, they *may hit procurement* especially hard.

In sum, and although there is a strong case to be made for beefing up the capabilities that we have in hand, we can expect to see some major force level increases in certain levels. These probably will not coincide with force reductions in other areas, but readiness and full capability for the U.S. posture as a whole may be jeopardized.

Among all the possibilities, preliminary indications are that U.S. force enhancement will be especially oriented to the strategic nuclear forces and to naval forces.[18] In October the President elected to pursue a very substantial strategic modernization program. Moreover, recent reports have appeared in the press that have indicated that naval

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[17] The figure is prepared from data in Budgets of the United States, for Fiscal Years 1976-1982.

[18] It is interesting to note that with the exception of R&D for some of the newer strategic programs (such as ABM), both of these activities generally will tend to spend out very slowly.

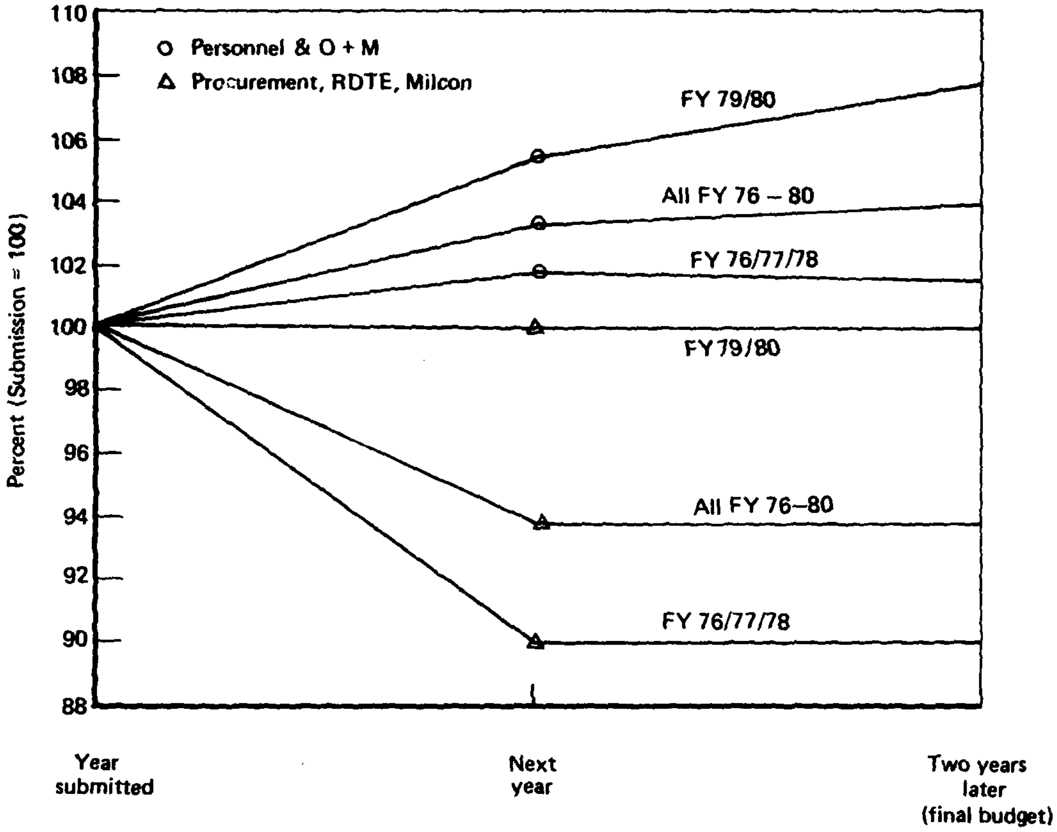

Fig. 5 – Percent shifts in investment and operations (FY 76-80)

force modernization could take precedence above other general purpose forces programs. Tactical air forces, popular in Congress and always a potential competitor for increased budgets, are for the most part currently at or beyond the peak of their acquisition schedules and most programs should be winding down over the next few years. Therefore, there may be no major surge in tactical air programs between upcoming program buyouts and the late 1980s and early 1990s when a new generation of forces may be due to begin coming on line. The biggest loser implied by these hypothetical budgetary priorities very probably would be conventional ground forces.

Summary

In sum, looking to the longer term, it is not now clear whether President Reagan's master economic plan will work out. Even so, the following two "scenarios" bound the range of possible defense budget outcomes, with the specific implications for the defense budget depending on the outcome of the Reagan plan.

If the plan does work, then we can expect to see some level of significant real defense budget increases by definition. Even so, other factors probably will exert a very strong pressure on the budget so that the pictures for real rates of defense budget growth, the cumulative value of the defense program over the next five years, and the composition of the DoD budget increase may not be as rosy as expected by the Administration at the outset of the program. The most likely source of pressure probably is Congressional reluctance to accept the risks of the economic plan, (or even if confidence is not lacking, the political difficulties that would be caused by it.) Though the effects of

"Reaganomics" could take at least a year or two to develop, the near term requirements of the defense budget are inescapable. Congress may attempt, under the circumstances, to defer some of the new defense requirements until the time that the economic plan has been validated.

If the Reagan economic plan does not work, the defense buildup could be in serious trouble. Specifically, if Federal revenues do not increase as a result of a reinvigorated economy, it is highly improbable that more severe cuts in the "balance of government" would be sufficient to pay for major real defense increases and would also be adequate to allow for the attainment of other Reagan administration economic goals. The Administration may opt for $100-150 billion deficits for a year or two, but the red ink cannot be allowed to flow for too long. Significant compromises between the long-term economic plan and the defense program would then have to be struck. It is impossible to say for sure, but the odds are that these compromises would not, in balance, favor defense activities.

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